

SUBJECT: ISRAEL: Will Debt Spoil the Outlook? 25X1

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Israel: Will Debt Spoil the Outlook []

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Summary

The Israeli economy has made great strides toward economic recovery in the past year, but continued progress will hinge on the government's willingness to reduce spending while holding the line on budget deficits. The budgetary process will come under added pressure in the final years of this decade when the government is scheduled to repay about \$4.7 billion to bank shareholders stemming from the bank share scandal--and subsequent stock market collapse--of October 1983. If the economy is not sufficiently stabilized, the large anticipated repayments--when combined with an already large outstanding debt repayment schedule--may strain the budget to the point that further spending cuts become difficult. []

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Israel's debt structure, although not presently a great burden on the economy, may in the next few years present serious problems for economic decisionmakers. This appears especially likely if borrowing--which constituted about 41 percent of total government revenue in Israeli fiscal year (IFY) 84/85--continues to play a leading role in financing government expenditure. If borrowing levels have to be increased--in response to greater revenue needs stemming from insufficient budget cutting action--the government will find an ever growing portion of the budget devoted to debt repayment. []

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DEBT STRUCTURE

[] the government is most concerned with domestic public debt growth. In 1985, domestic public debt--defined as total private sector claims on the public sector--stood at 143 percent of GNP, up from

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This memorandum was prepared by [] the Israel-Jordan-PLO Branch, Arab-Israeli Division, Office of Near Eastern and South Asian Analysis. Information as of 22 August was used in its preparation. Questions and comments should be directed to Chief, Arab-Israeli Division []

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123 percent of GNP in 1984. This ratio is likely to increase greatly in light of the large anticipated bank share repayments the government will undertake from 1987 to 1989. [REDACTED]

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The government appears more confident it can handle foreign debt due to its smaller relative size in the overall debt structure. Foreign public debt--total claims by foreigners on the public sector minus foreign reserves--stood at 60 percent of GNP in 1985, up from 51 percent the previous year. [REDACTED]

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Debt maturity length--although not currently a problem--could become a more important issue as the decade draws to a close. At yearend 1985, short-term debt constituted 14.7 percent of total debt, medium-term debt 15.3 percent, and long-term debt the remaining 70 percent. This debt distribution may change drastically, however, if the economy fails to achieve sustained economic growth and additional budget cuts are not forthcoming. Without continued spending restraints, revenue shortfalls may necessitate increased borrowing. Increased borrowings through short-term loans would be a two-edged sword for Israel: on the one hand, Israel would be able to cover revenue shortfalls but a greater burden would be imposed since the government would have to refinance a larger debt more frequently. Additional borrowings in 1986 and 1987 would further compound financing problems in 1987 and 1988 when the bulk of the bank share repayment is to take place. [REDACTED]

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BANK SHARE DEBT FALLOUT

The bank share scandal and subsequent stock market collapse of October 1983--caused by the questionable stock trading practices of Israel's leading banks--was resolved at the time when the government agreed to purchase back from individual shareholders the full value of their shares, thereby assuming a large future debt obligation. Under terms of the bank stock guarantee program, the government promised to redeem or purchase from shareholders shares worth \$6.5 billion. To date, the government has purchased about \$1.8 billion, leaving \$4.7 billion still to be redeemed. Current plans call for the government to absorb \$1.0 billion in either 1987 or 1989 while redeeming \$3.7 billion in 1988. [REDACTED]

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The 1987 or 1989 bank stock repayment of \$1.0 billion should not overly strain the economy, but the 1988 repayment of \$3.7 billion may have negative long-term implications. The government's most likely approach will be to redeem the \$3.7 billion in shares through a firm created by the government and eventually to resell them to the public. The government would lend the firm the necessary funds to buy the shares. By 1993, the firm must either repay the government or the government would have to reclaim the shares or transform the \$3.7 billion loan to the firm into a grant. [REDACTED]

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In any case, the government will have to make interest payments to bank stock shareholders on any replacement bonds or paper issued. Larger interest payments--when combined with increased total internal debt--will increase the pressure to compromise in the budgetary process. Budgetary inaction--in which no further steps are taken to reduce the budget deficit--would likely result if the government were faced with the

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difficult task of drastically cutting back on social services to accommodate larger anticipated debt service payments. [REDACTED]

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WHEN IS DEBT UNMANAGEABLE?

Manageability of external debt by a country is generally determined by the ability to service the debt on a timely basis. This, in turn, depends on several factors, including inflows of foreign capital, growth of exports, control of import growth, and exogenous factors such as commodity prices and interest rates. Countries therefore can run into debt problems through their own mismanagement or from external economic conditions. [REDACTED]

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Various ratios may be used as indicators of debt servicing problems. The traditional debt service ratio indicates what share of exports, the principal foreign exchange source for most countries, is being devoted to servicing the debt. A ratio of 50 percent or higher usually signifies a strain on a country's resources. Similarly, total debt compared to gross domestic product generally indicates the burden of the debt on a country. Another key indicator is the ratio of net foreign capital inflows to debt service payments. As long as this ratio is greater than one, the country should be able to meet its debt obligations; if the figure falls below one, the country would have to run a trade surplus or draw down foreign exchange reserves to avoid a liquidity problem. [REDACTED]

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Thus, external debt problems will arise if a country's international payments cannot be balanced without major changes in the level of either imports or debt servicing. In general, a problem can be traced to specific components of the balance of payments. Such items could include: export shortfalls due to declining commodity prices or world recession, reductions in worker remittances, excessive imports due to an overvalued exchange rate or price rises, higher interest payments because of increasing world interest rates, a slowdown or cessation of foreign capital inflows, capital flight, or a bunching of amortization payments. [REDACTED]

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With regard to domestic debt, the main concern is with choosing a maturity structure for new debt issues that minimizes debt servicing interest costs and at the same time enhances monetary stability. Problems occur when interest costs are high with debt at long-term maturities and when a large volume of short-term debt at low interest rates acts as a substitute for money and continually needs to be refinanced. [REDACTED]

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HOW DOES ISRAEL STACK UP?

By using the various debt ratios outlined above, Israel does not presently appear to have significant debt servicing problems. The debt-service ratio, which expresses debt service payments as a percentage of export earnings, stood at 42.1 percent in 1985, up only marginally from the year earlier figure of 41.8 percent.

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Furthermore, the ratio of total debt to GNP was 139 percent last year while the ratio of net foreign capital inflows to debt service payments was 1.11, both within the bounds of debt manageability. [REDACTED]

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Current conditions, however, could change drastically in the next few years. Poor export growth, when combined with the upcoming bank share repayments, may push the debt-service ratio over 50 percent, straining an already financially strapped Israeli economy. In addition, any decline in US economic assistance, which makes up a large part of net foreign capital inflows, would add to a worsening debt situation.

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OUTLOOK

Israel's long-term economic outlook depends not only on the ability of the economy to sustain meaningful growth while fundamental changes in the economic system are implemented, but also on the government's ability to keep debt growth within manageable bounds. If the economy fails to perform up to expectations, the government will be hard-pressed to undertake meaningful long-term economic reforms. A sputtering economy may then lead to an increasingly larger share of the government's budget being devoted to debt repayment. [REDACTED]

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The scheduled government rotation in October will be an important test because if then Prime Minister Shamir can build upon the economic gains achieved by Peres, the economy will be better able to weather larger debt payments. Given Likud's poor economic track record, however, it may encounter serious problems in coordinating economic policy with Labor, thereby imperilling the gains made during the past year and worsening prospects for controlling debt in the future. [REDACTED]

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APPENDIX: ALTERNATIVE DEBT SCENARIOS

Two scenarios can be developed to show what might happen to debt over the period 1986-1990. It should be stressed that the scenarios are not forecasts, since actual debt behavior is conditional upon the economy's performance and on government economic policies. As such, the scenarios should be taken as conditional forecasts. Using a simple model of internal and external debt, the scenarios assume that

- the government's budget deficit is a fixed fraction of GNP
- the deficit in the current account of the balance of payments is a fixed fraction of GNP
- real internal and external debt interest rates are fixed
- GNP grows at some constant, fixed rate
- changes in nominal monetary stocks are ignored,

Scenario one assumes the government's budget deficit and the current account deficit remain at 5 and 20 percent respectively of GNP for the period, real interest rates are fixed at 5 percent, and GNP grows at 2 percent annually. If bank share repayments are not allowed for, the debt/GNP ratio falls from 1.43 in 1986 to 0.97 by 1990.

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Scenario two assumes the bank share repayments are fully paid by the government in 1987 and 1988 along with assuming that the government's budget deficit and the current account deficit remain at 15 and 20 percent of GNP respectively after 1987 while real interest rates are fixed at 5 percent and the economy grows at a 2 percent annual rate. Under **scenario two**, the impact of the bank share repayment scheme is evident as the debt/GNP ratio would fall to 1.37 in 1987, increase to 1.54 in 1988--as the large \$3.7 billion payment is fully absorbed--while increasing to 1.59 in 1989. While the forecast results are only conditional at best, they do illustrate the potential problems for economic decisionmakers if debt levels mount under the weight of the bank share repayments and the economy's performance remains unimpressive.

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